OMFIF
Official Monetary and Financial Institutions Forum

Gold, the renminbi and the multi-currency reserve system

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This report has been commissioned by the World Gold Council as part of a series of reports analysing the role of gold in the International Monetary System.

WORLD GOLD COUNCIL

About the World Gold Council

The World Gold Council is the global authority on gold and its uses and the first source of informed opinion and advice for stakeholders and decision makers. We use this knowledge to develop insights into the future role that gold can play across a number of sectors and then, in collaboration with partners, intervene to deliver solutions and create new markets, and to increase and sustain the demand for gold.

In the Investment sector we make gold fundamental to investment decision making.

For Governments and Central Banks, we are a trusted advisor to policy makers and reserve asset managers on all matters related to the gold market.

In the Jewellery sector, we create new insights and ideas which increase the allure and significance of gold when given or worn.

In the Technology sector, we work to place gold at the heart of technological advancement, and we are the authority on innovative uses of gold in industry and society.

As the global advocate for gold, we are committed to playing a key role in the development of a responsible gold mining industry. Our members, the leading gold mining companies, regard the management of the local environment and relationships with local communities as paramount considerations during the lifetime of any mine project. Together, we work to ensure the industry as a whole is striving to develop and integrate best practice.

All our work is informed by a deep understanding of the wide role gold has in society and its potential both now and in the future. Through commercial partnerships and industry leading research, we develop a clear understanding of, and insight into, each of its key markets. Using this insight, we create new, relevant and innovative solutions that deliver against clearly identified market needs. Our insight adds value to our partners and stakeholders across all sectors, and informs each of our programmes and market interventions.

Foreword

Filling the vacuum

Meghnad Desai, Chairman, OMFIF Advisory Board

The world is preparing for possible twin shocks from the parlous position of the two main reserve currencies, the dollar and the euro. As China weighs up its options for joining in the reserve asset game, gold – the official asset that plays no formal part in the monetary system, yet has never really gone away – is poised, once again, to play a pivotal role. Many dismiss gold as a relic of the past or as an inadequate hedge against inflation. But from an asset management point of view, as well as on the basis of political analysis, gold has a lot going for it; it correlates negatively with the greenback, and no other reserve asset seems safe from the coming dollar shock.

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If the spectre of collapse continues to haunt the main reserve assets, and on the expectation that the renminbi will take time to get into its stride, the world will rush to safe havens. Gold may be the only one with the requisite size, clout and – dare I say it – history to help ward off the strains that will beset the world monetary system. It would be wise to draw up contingency plans for such eventualities.

In a sense, we have been here before. The twin centrepieces of the Bretton Woods system, the dollar and sterling, were both under strain as a result of economic weaknesses in the 1960s and 1970s, which marked the start of a debate that has continued since then on the gradual development of a multi-currency reserve system. Curiously, the main beneficiary at the time was the German D-Mark, the currency that has bequeathed the euro, presently under strain as the result of the great economic and political divergences at its very heart. But, compared with the previous transition, there are great differences. Let me list five of them.

First, the west has been assailed by the longest-running economic crisis since the 1930s, hollowing out the natural ambitions of the countries that used to run the world, and weakening the natural pull of the US and European currencies.

Second, Asia is rising in the economic and political firmament, reinforced by the resistance of the Asian economies to the transatlantic financial crisis and their governments' determination to learn from their own and others' past mistakes.

Third, China and Asia have over-saved, partly because of massive perceived shortcomings in the International Monetary Fund's intervention in the 1997-98 Asian crisis. These countries have amassed huge surpluses in the form of massive monetary reserves that have become the most potent factor behind reserve diversification into other assets including gold. The IMF's belated recognition in December 2012 of the occasional need for temporary capital controls demonstrates how dealing with world imbalances in a way consistent with emerging market needs has become a new force in international policy thinking.

Western economies have attempted to dismantle gold's monetary role. This has failed.

Fourth, with the rise of the renminbi, despite all the evident handicaps attending to its potential reserve status, Asia has a champion with which to confront the supremacy of the western currencies.

Fifth, and most crucial with respect to the role of gold, the previously dominant western economies have attempted to dismantle the yellow metal's monetary role, and – for a variety of reasons – this has comprehensively failed. Gold thus stands ready to fill the vacuum created by the evident failings of the dollar and the euro, and the not-yet-requited ambitions of the renminbi.

Much needs to be done, of course, to prepare the Chinese currency for reserve status. This could take years, and there could be setbacks. The danger of perturbations along the way is likely, all the more, to underpin gold's role as an alternative reserve asset.

The Chinese authorities' own evident leaning towards building up stocks of monetary gold, reflecting a cultural attachment to precious metals that goes back millennia, is itself a powerful factor in the equation.

When it comes to international monetary reform, well before the renminbi advances to fully-fledged reserve currency status, gold might stand to reclaim a right to which it has long aspired by returning to the heart of the system. Rebuilding and reinforcing the Special Drawing Right (SDR), the IMF's composite currency spawned in the 1960s, have been much mooted, but nothing has been done to realise this aim.

I favour extending the SDR to include the R-currencies – the renminbi, rupee, real, rand and rouble – with the addition of gold. This would be a form of indexation to add to the SDR's attractiveness. Gold would not need to be paid out, but its dollar or renminbi or rouble equivalent would be if the SDR had a gold content. By moving counter-cyclically to the dollar, gold could improve the stabilising properties of the SDR. Particularly if the threats to the dollar and the euro worsen, a large SDR issue improved by some gold content and the R-currencies may be urgently required.

In its absence, we may face a huge liquidity crunch if a combination of US and European shortcomings and the natural ambitions of Asia produce an attack on the major currencies – and open up a further hole in the framework of the world's reserve currency arrangements.

As the international community attempts to take on these challenges, gold waits in the wings. For the first time in many years, gold stands well prepared to move once more towards the centre-stage. This could be the start of an immensely important phase in the history of world money.

Contents

Overview and summary

The international monetary system is on the brink of change. The role of the US dollar as the primary reserve currency is being challenged in multiple ways. These points find unequivocal agreement. However, there is a great debate on the system's future shape.

Will the dollar be replaced by another reserve currency? Will we enter a new multi-currency system? What will be the place of China as the world's No. 2 economy? Is there a role for gold in the new system and, if so, what will it be? These are the questions academics, central banks and policy-makers are considering around the world. In this paper, we point the way towards some answers.

The Official Monetary and Financial Institutions Forum was created during the financial crisis in large part to explore fundamental questions about the international monetary system. These are the big issues that central banks, finance ministries and capital market practitioners must address.

Through rigorous historical and contemporary analysis and discussions with policy-makers and financial experts around the world, OMFIF concludes that:

1. The world is headed towards the uncharted waters of a durable multi-currency reserve system, where the dollar will share its pivotal role with a range of other currencies, including the renminbi. Historical precedent and the underlying principles behind asset diversification indicate that the coming time of flux and uncertainty for world-wide reserve management will be a period when reserve holders spread their investments into a relatively wide range of assets and sectors.

2. Amid the new interplay of forces impinging on worldwide official investment, gold seems likely to play an important role. In particular, OMFIF believes that the role of gold in the international monetary system will be further enhanced in the coming 10 years as a result of basic uncertainties over the dollar and the euro, and over whether the renminbi can emerge as a robust international currency without encountering fundamental setbacks.

3. China will rise as the US wanes, but this rebalancing will occur gradually rather than abruptly and setbacks and perturbations are likely along the way. China's rise will inevitably be riddled with political and economic challenges that lead to a long period of transition.

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As China aspires to take the lead politically and economically, it is unlikely to be satisfied with storing its wealth simply in liabilities of other countries.

These conclusions are based on analysis of the following topics in five chapters:

Chapter One: The lessons of history
The evolution of reserve currency patterns from the British pound to the US dollar provides two lessons for today. First, gold's monetary use rose during the transition; second, the role of geopolitics in the international monetary system increased as the system became more complex.

Chapter Two: The world monetary system at a crossroads
The rebalancing of the global economy – with the east once again home to some of the most important world economies – means that growing international reserves will naturally become more diversified away from one reserve currency: the dollar. Furthermore, as China aspires to take the lead politically and economically, it is unlikely to be satisfied with storing its wealth simply in liabilities of other countries. Both factors are likely to lead to gold playing a more important role.

Chapter Three: China's position: requirements, priorities, constraints
Questions over the role and scope of the renminbi go to the heart of world politics and the international trading economy. For fundamental geopolitical reasons, because of national pride and prestige, as well as for profit and convenience, China wants to see its currency play a greater role in the international capitalist system. But it is hemmed in by a variety of constraints, some of its own making, others stemming from the rest of the world's policies.

Chapter Four: The outlook for the next five years (2013 to 2018)
Whether the world moves into full crisis with the end of the euro, or whether we have a recovery, or whether we experience something in between: all paths lead to towards a multi-currency system, in which gold's role is likely to become more significant.

Chapter Five: The future of gold in the international monetary system
With the evolution towards a constellation of multiple reserve currencies, gold – as an asset that is no one's liability – will play a special role. Gold will neither replace fiat currencies, nor be the dominant 'currency' in the system. But it will become increasingly sought after and will attract a higher level of attention from policy-makers and financial market practitioners.

Chapter One

1 Renminbi internationalisation and the implications for gold

The dollar's pre-eminent role

The dollar has been the world's main reserve currency since the First World War. True, the pound sterling, buffered by the British Empire, remained a key reserve currency, certainly so after Britain returned to the Gold Standard in 1925. But leaving gold in 1931 was a major blow and the role of sterling entered into prolonged decline.

Victorious Britain's near-bankruptcy at the end of the Second World War inevitably created a further drag on the currency. Once the British government was forced to call on the IMF for help in 1976, any pretence that sterling was a credible reserve currency had gone.

Smaller currencies have seen some use as foreign exchange reserves, and gold has retained its role, albeit diminished. But two recent developments have changed this situation. One is EMU; in spite of its current problems and the doubts over its future, the euro remains a potentially credible challenger and an attractive alternative to the dollar. The second is the development of China and the renminbi.

Smaller currencies have seen some use as foreign exchange reserves, and gold has retained its role. But the euro and the rise of China have changed this situation.

The renminbi's challenge

The rise of China to become the world's second-largest economy has brought a potential new currency into play. By becoming essentially capitalist, China has the potential to make the renminbi a reserve currency. It also has the desire to do so, if not on a global basis then certainly regionally. Yet the renminbi's advance cannot take place either rapidly or smoothly. The Chinese currency is handicapped by a number of factors that mitigate against its attaining similar status to the dollar.

The Chinese authorities can influence whether and how rapidly the renminbi moves towards reserve currency status. But this is an international issue of great sensitivity and the Chinese authorities will tread carefully, not least because the Chinese currency is not the only candidate for greater importance. In past decades, foreign critics (especially from Europe, but also from developing countries) have regularly assailed the US for profiting from the 'exorbitant privilege', in particular the semi-automatic rewards for the issuer of reserve currency dollars and losses for the countries that end up holding them.[2] With the advent of the euro, there is for the first time a credible challenge to the dollar. China appears to have decided that the renminbi will also be one of the assets taking up a reserve role, in a volume and at a pace that both the Chinese authorities and the world community as a whole will decide.

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The role of gold

China has stated that it is dissatisfied with the present dollar-orientated system. Yet it is still a long way from setting out a means of replacing present arrangements with something different.

At this time of transition for world money, gold has three major advantages. First, it is historically – at least during the era of the Gold Standard – a hedge against deflation. For much of the post-Second World War era, this has not been a particularly relevant consideration. However, the world is still in the grip of a financial crisis primarily induced by excess debt. Widespread inflation is unlikely to be a possible or attractive solution to this.[3] This means that the solution is likely to involve a long period of deleveraging, which implies at the very least deflationary pressures. Gold could thus return to fulfilling one of its traditional roles. Second, gold is nobody's liability. Third, and following on from this, it is a hedge against other reserve currencies. To put it differently, gold is a geopolitical hedge and this also means a dollar hedge.

The future composition of official reserves, and the role gold plays, will be affected by a range of factors. Doubts over US willingness and/or ability to tackle underlying fiscal imbalances represent just one element of uncertainty. If there are big question marks over the economic rise of China, then these surround, too, the economic stewardship of the other main creditor countries, Germany and Japan; fundamental flaws have also emerged over the euro.

Against this background, it is not surprising that central bankers seem to have reappraised the role of gold as an intrinsic part of central banking reserves. This has been seen in the refusal of the main holders – US, Germany and Italy – to sell in recent years, and in the big increase in purchases by emerging market economies (led by China and India, but including many other nations).

New activism by official sector asset managers around the world is a result of two interlinked factors. First, these managers are becoming more exposed to criticism that their policies (or those of their political masters) are causing actual or potential losses. Second, they are under greater pressure than before to turn their activities into profit centres (partly because of pressure on other parts of central banks' balance sheets).

In its stance on renminbi internationalisation, the Chinese leadership seems to be moving towards modifying its hitherto piecemeal approach, placing its moves in a better-articulated political and strategic context. China has stated that it is dissatisfied with the present dollar-orientated system. Yet it is still a long way from setting out a comprehensive means of replacing present arrangements with something different. While this uncertainty persists, reliance on gold is likely to be reinforced.

Chapter Two

2 World monetary system at a crossroads

Macroeconomic background

Foreign exchange reserve holdings have changed in a number of ways over the past 15 years. Total foreign exchange reserves have risen sharply; the role of the dollar, while still pre-eminent, has diminished somewhat; and there has more recently been a renewed interest in gold. The reasons behind these developments vary. One is the aftermath of the 1997-98 Asian crisis, after which Asian economies decided to build up foreign exchange reserves to a level where they would not be in danger of once again having to take what was widely perceived as humiliating advice from the IMF in return for credit support packages. Another reason is the rise of China to become one of the world's largest economies; and, connected with this, the financial crisis that erupted in 2007-08.

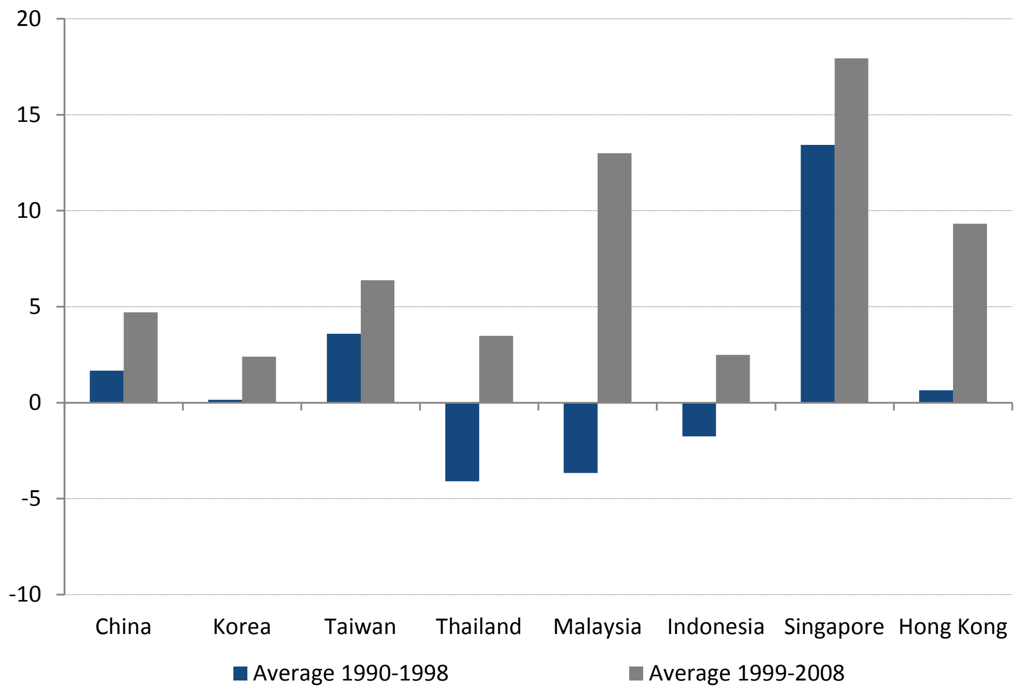
Asian central banks' shares of world foreign exchange reserves rose from around 25% in the early 1990s and 30% in 1998 to slightly more than 45% by 2011.

For the Asian countries, these factors combined to produce a policy of intensified export-led growth, accompanied by measures to dampen domestic economic demand as well as central bank intervention to prevent undue currency appreciation and sustain exports. Strong output growth was accompanied by rapidly widening current account surpluses (Chart 1) and by a sharp build-up of foreign exchange reserves among the Asian nations, which soon eclipsed those of the western countries that had traditionally dominated the world monetary scene (Chart 2). Asian central banks' shares of world foreign exchange reserves rose from around 25% in the early 1990s and 30% in 1998 to slightly more than 45% by 2011.

The necessary counterpart to large Asian current account surpluses was a sharp increase in current account deficits in other, mainly western, countries, producing an overall level of world economic disequilibrium that proved unsustainable and culminated in the crash of 2007-08.

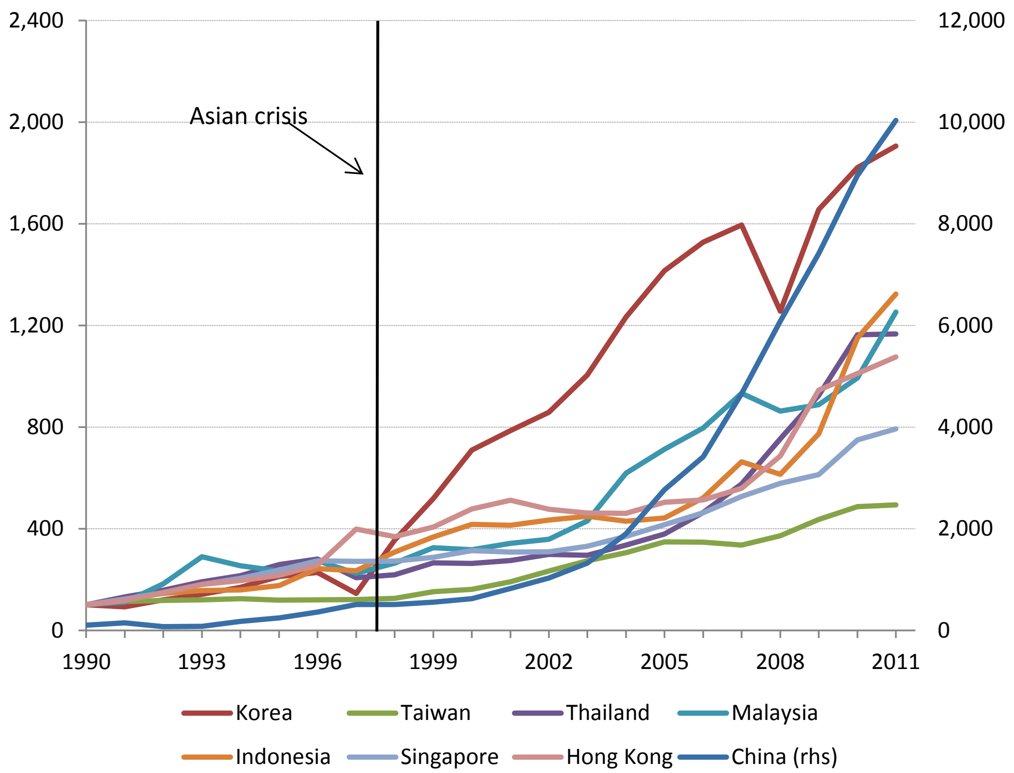
The successful build-up of reserves fulfilled one significant aim of the Asian countries. But a second objective, decreased dependence on the dollar through diversification of these reserves, was less easily achieved. According to the IMF, the share of the dollar in identifiable foreign exchange reserves rose from 65.2% in 1997, to 71.5% in 2001.[4] Since then it has declined to 62.2% by Q1 2012; but the dollar remains by far the world's most important reserve currency.[5] The main reason for this is that, if the Asian countries wanted to keep their exchange rates artificially low against the dollar (and perhaps too against the renminbi), they had no choice but to build up dollar reserves.

Chart 1: Current account balances, key Asian economies, % of GDP



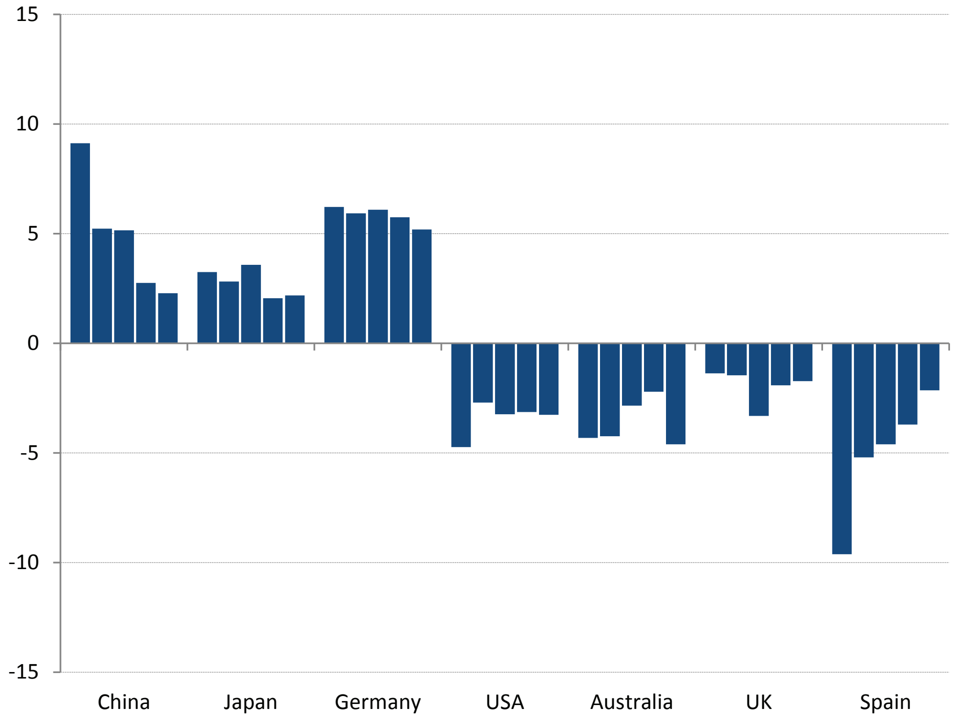
Source: IMF World Economic Outlook April 2012

Chart 2: Foreign exchange reserves, SDRs (index 1990=100)



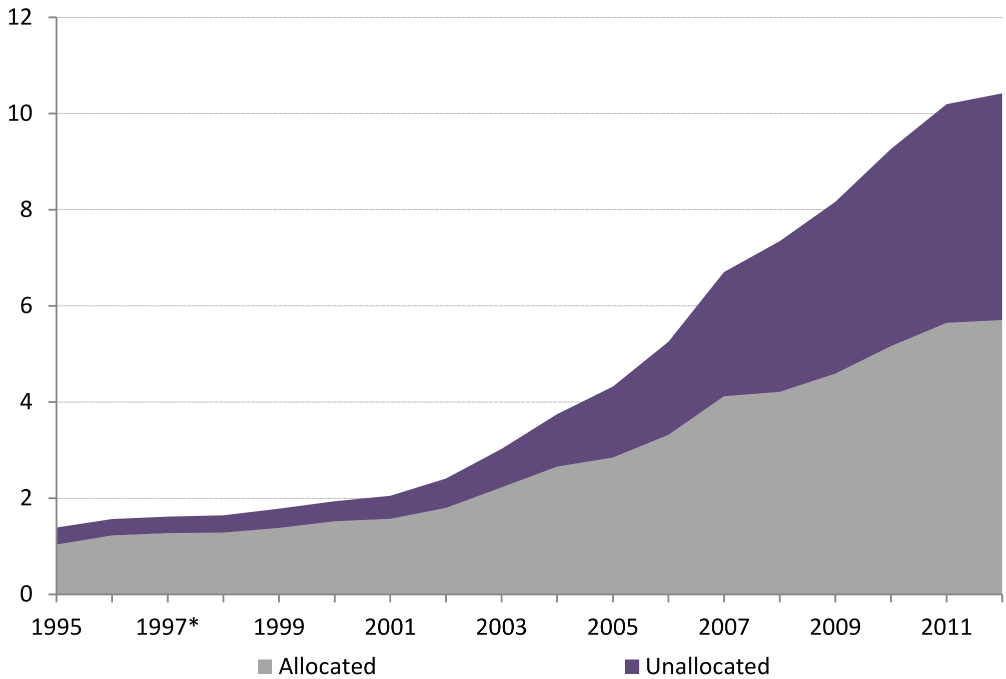
Source: IMF International Financial Statistics

Chart 3: Current account balances, % of GDP 2008-2012 (2012 IMF forecast, April 2012)



Source: IMF World Economic Outlook April 2012

Chart 4: Total foreign reserves, allocated and unallocated, $tn



Source: IMF Composition of Foreign Exchange Reserves

Correcting international imbalances and reserve composition

For much of the period 2007-12 the dollar has held up; but this is very much because it was the least unattractive in a rather unattractive group.

Five years after the financial crisis erupted, global financial imbalances remain. That is partly because, in the immediate aftermath of the 2007-08 financial shocks, deficit countries moved to shore up their economies by shifting to more public sector borrowing, which had the effect of prolonging current account surpluses and deficits for longer than would otherwise have been the case (Chart 3). But this trend has proven unsustainable and both the private and public sectors in these countries are now trying to deleverage.

This is a primary reason for world economic weakness in 2012, which, in turn, causes further deterioration in the public finances of the spender countries. That then gives rise to fresh uncertainty, for example in the form of the possible temptation for countries eventually to inflate away their debt. Although, in OMFIF's opinion, this is not a likely development, the fear (for example among US creditors) that this will happen is a powerful potential drag on the dollar. For much of the period 2007-12 the dollar has nevertheless held up; but this is very much because it was the least unattractive in a rather unattractive group (including the euro and sterling etc.). According to the IMF figures, the different currencies' shares of declared foreign exchange reserves have remained broadly stable since 2008, particularly when taking into account exchange rate moves (Table 1). But it is not clear whether this is a fully stable equilibrium, not least because the numbers are not comprehensive, reflecting a large increase in the share of 'non-allocated' reserves (Chart 4).[6]

The one significant change is the rise in the share of 'others', which has more than doubled since 2008. With serious doubts about the sustainability of US public finances, and even greater uncertainties about the euro, the attraction of alternative assets is obvious. However, the liquidity in alternative currencies, in both developed and emerging market economies, is too small to allow for any major shift into them. Nor is it clear whether the attraction of alternative currencies will remain once the world economy fully recovers. In the case of the renminbi, provided the Chinese economy does not run into major squalls, its attractiveness – in view of the sheer size of the Chinese economy and the Beijing authorities' ambitions for internationalisation should remain and even increase.

Table 1: Share of currencies in total identified holdings of foreign exchange reserves

	2008	2009	2010	2011	2012
US dollar	64.1	62.0	61.8	62.2	62.2
Sterling	4.0	4.2	3.9	3.8	4.0
Yen	3.1	2.9	3.7	3.5	3.6
Euro	26.4	27.7	26.0	25.0	24.9
Other	2.3	3.2	4.6	5.4	5.3

Source: IMF Composition of Foreign Exchange Reserves

Chapter Two

The consequences of shifting economic power

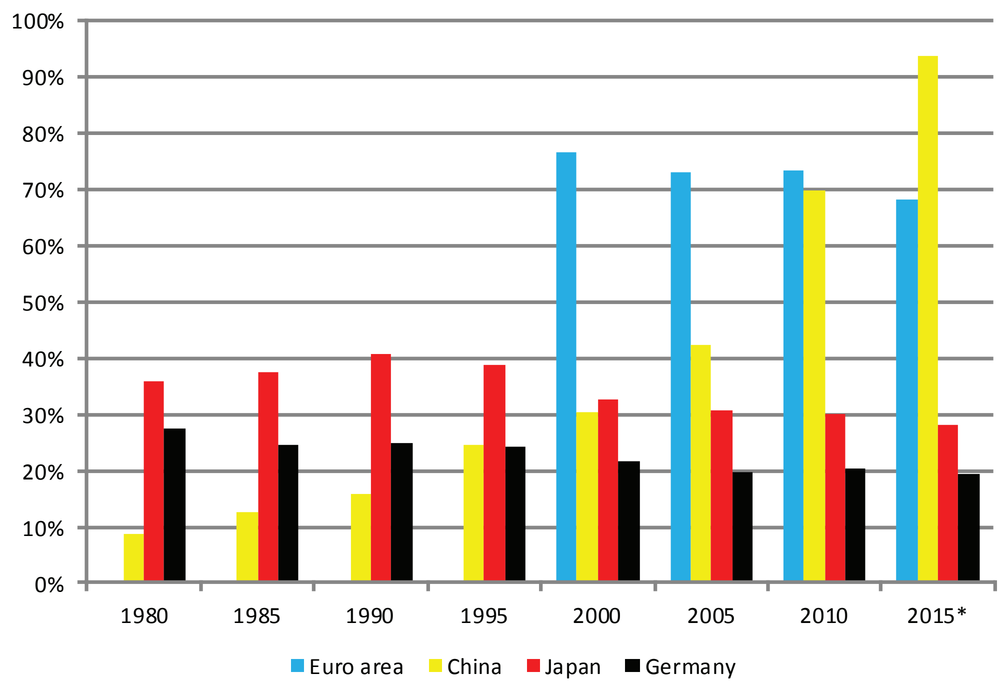
Economic power has shifted throughout history. Two millennia ago, East Asia was considerably wealthier than Europe. From the 16th century onwards, world economic power lay in Europe. However, following the end of their civil war in 1865, the rapidly industrialising and expanding US eventually became the world's paramount economic power. The 20th century was the American Century. We are now witnessing another transition, where the world has gone full circle and east Asia is once again home to some of the most important world economies.

However, it is still far too early to write off either the US or its currency. The US remains the world's largest economy and is in many ways more dynamic, powerful and productive than most, if not all of its competitors. The phenomenon of 're-shoring', i.e. US manufacturing moving back to America from China and other emerging markets, shows that the US cost/productivity mix remains attractive and that the shift in economic advantage is far from being a one-way street. Moreover, in some ways, we have been there before. In the 1970s and 1980s, Japan and to a lesser extent Germany were frequently touted as rivals that could eventually overtake the US. Yet the Japanese economy peaked at 41% the size of the American in 1991 and has since slipped to less than 30%; the German edged above 27% in 1974, but has in spite of reunification in 1990 slipped back to being less than 20% of the US (Chart 5).[7]

Neither the D-Mark nor the yen ever achieved anything near parity with the dollar in terms of reserve currency status. The yen's (declared) share of total foreign exchange reserves never even reached 10%, while the D-Mark's share only briefly exceeded that figure.[8] Even the euro, incorporating D-Mark, French franc, Dutch guilder and ECU reserves, never saw its share rise above 30%, while in recent years its share of foreign exchange reserves has dropped to below 25% (Table 1 and Chart 6). The share of other currencies in identified official reserves has remained small relative to the dollar.[9] But looking purely at the share of foreign reserves is somewhat misleading. Neither Germany nor Japan really wanted their currencies to become significant reserve currencies. By contrast, the Chinese authorities have made it clear that they want the renminbi to become a reserve currency, if not globally then at least regionally, as part of an overall plan to increase the size and wealth of the Chinese economy.

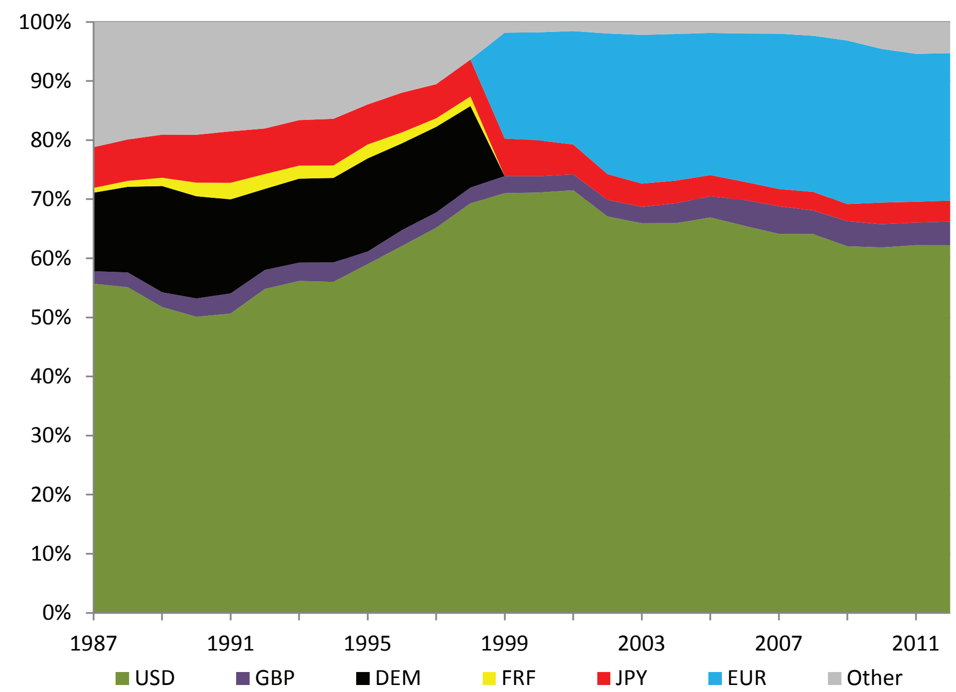
Neither Germany nor Japan wanted their currencies to become significant reserve currencies. By contrast, the Chinese authorities have made it clear that they want the the renminbi ultimately to become a reserve currency.

Chart 5: GDP of respective country as percentage of US GDP, current international dollars at PPP, 2015 - IMF forecast*



Source: IMF, World Economic Outlook

Chart 6: Share of currencies in total identified official holdings of foreign exchange reserves



Source: IMF Composition of Foreign Exchange Reserves

Diversification, the renminbi and gold

By itself, the internationalisation of the renminbi need not affect gold. However, as part of a general move towards diversification of international reserve holdings, there is likely to be a clear role for gold.

Commentators frequently point out that too rapid diversification would risk triggering a precipitate fall in the US currency, which would erode the value of China's remaining dollar holdings.

One reason is that China has no wish to be unduly dependent on either the dollar or the euro. This is not a specifically Chinese issue, rather one that is related, at least in part, to being the issuer of a reserve currency. A reserve currency country is unlikely to wish to spend funds building up assets that are someone else's liability. Unsurprisingly, the main other issuers of reserve currencies, the US and the euro area, are also the biggest holders of gold relative to their total foreign exchange holdings (Table 2). The Chinese authorities have already been diversifying their own reserves, a move that has run parallel in recent years with modifying the renminbi/dollar peg. The euro's share of Chinese international reserves appears to have been in line with the international benchmark (around 25% in recent years) with the dollar accounting for around 65%.[10] Chinese officials and outside commentators frequently point out that too rapid diversification would risk triggering a precipitate fall in the US currency which would erode the value of China's remaining dollar holdings. Similar considerations apply, too, to the euro: during a period of euro weakness, an over-rapid move by China to sell euros would also damage the value of a core holding, although it would boost the value of the dollar.

Comments by Chinese policy-makers indicate that Beijing sees little chance of a rapid resolution of the euro area's financial and sovereign debt crises. There will be sufficient question marks over the euro to make large-scale euro-based investments, particularly in the traditional area of Europe's sovereign bond markets, less attractive; but the alternative of a substantial move away from the euro looks unrealistic.

Whatever the doubts and possible setbacks pertaining to the world's two main reserve currencies, the size of China's foreign exchange reserves is such that there really are no other currency options apart from the dollar and euro for the greater part of them. This is likely to have been an important reason why the Chinese authorities have decided in recent years to boost the share of gold in reserves.

Table 2: Gold as % of total foreign reserve holdings including gold (2011)

World	14.4
US	74.5
Germany	71.4
France	71.1
UK	16.2
Russia	8.7
India	9.2
Japan	2.9
China	1.6

Source: World Gold Council / IMF [12]

Role of gold in the multi-currency reserve system

For central banks, concerned with preserving value and naturally politically cautious, gold will prove a haven from currency storms.

The role of gold during and after a move to a multi-currency reserve system is an important issue. Gold will probably play a greater role during the transition period. This is likely to be a period of substantial fluctuation in currency values as market actors attempt to find a new equilibrium. That is where the attraction of gold, an asset which is nobody's liability should stand out: investing would denote no political bias and which should minimise foreign exchange fluctuations. For central banks, concerned with preserving value and naturally politically cautious, gold is likely to prove a haven from currency storms.

There are several factors that could influence the importance of gold once a multi-currency reserve system is in place. In such a system, the role of gold is likely to alter somewhat, allowing it to become, as it were, one asset (if with certain peculiar advantages and disadvantages) among others. In fact, judging by recent developments in central bank balance sheets, gold is only one of a series of assets that will become more relevant.[13] But there are also limiting influences, partly reflecting the limited availability of gold. Financial market gold amounts to about 60,100 tonnes.[14] Unless one assumes a major shift from jewellery/industry demand to financial use, gold reserves remain mainly a zero sum game, with the only increases coming from new mining (approximately 2,500 tonnes per annum) and from recycling (slightly less than 1,600 tonnes per annum).[15] This amounts to an increase in available gold stocks of just above 4,000 tonnes per annum or 6.7% of financial market gold. Net buying by official institutions of 400 tonnes of gold in 2011 (around one-tenth of the annual increase in gold supply) was the largest volume of net purchases in four decades.

The drawback of gold – the lack of yield – means that buying in a bull market only becomes attractive if one assumes the bull market will continue.

Further central bank demand could therefore risk pushing up gold prices, potentially to a point of making it unattractive as an investment. The drawback of gold – the lack of yield – means that buying in a bull market only becomes attractive if one assumes the bull market will continue. Moreover, if central banks take a more active interest in gold, they are likely to be imitated by private sector investors, de facto diminishing the amount of extra gold available as reserves.[16]

This set of considerations makes it unlikely that gold could re-emerge as a significant threat to fiat currencies, in the sense that it could replace them in a systemic way. The (relative) scarcity of gold means that it could only ever replace a fiat currency on a fractional basis. However, even such a system is unlikely. That worked during the Gold and Gold Exchange Standards, mainly because politicians and markets had faith in them. When that faith broke down, in 1914, in the early 1930s and early 1970s, the system could no longer be maintained.

Precisely because of that experience and of the constant temptation for politicians to manipulate a standard to their short-term advantage, we will probably never see the return of a fractional Gold Standard. The flexibility – for better or worse – of fiat currencies makes it unlikely that politicians will accept abandoning them. Yet the legacy remains. Any sizeable increase in distrust of politicians, founded on suspicion that they – or central bankers – are debasing the currency, is likely to increase the attraction of gold as a hedge against all currencies.

Chapter Three

3 China's position: requirements, priorities, constraints

A role for the renminbi

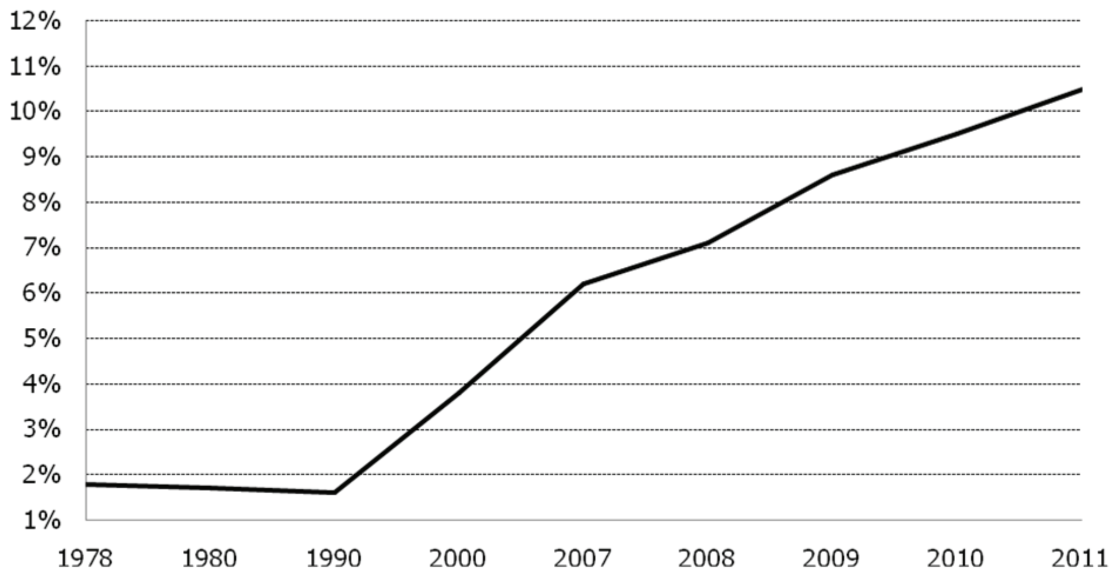
The debate about internationalising the Chinese renminbi is one of the most important issues in global politics and economics. Focusing on the power relationship between the world's two largest economies, the US and China, questions over the role and scope of the renminbi go to the heart of world politics and the international trading economy. For fundamental geopolitical reasons, because of national pride and prestige, as well as for profit and convenience, China wants to see its currency play a greater role in the international capitalist system. But it is also hemmed in by a variety of constraints, some of its own making, others stemming from policies in the rest of the world.

The Chinese authorities distinguish between means and ends. The overall aim is not attaining reserve currency status. Rather it is optimising China's economic power, resilience and prosperity.

As Chinese experts and officials repeatedly stress, China is the only one of the world's six biggest economies that does not have reserve currency status.[17] China's share of the world economy has risen more than fivefold in the past 30 years (Chart 7), while its share of world trade has increased threefold in the past decade (Chart 8). Many years will elapse before the renminbi mounts a credible challenge to the dollar. Yet China's oft-stated ambitions – and the evident inconsistencies between China's economic size and the clout of its currency – effectively bring the world monetary system into a new phase of flux and uncertainty, with considerable implications for gold as one of central banks' primary reserve assets.

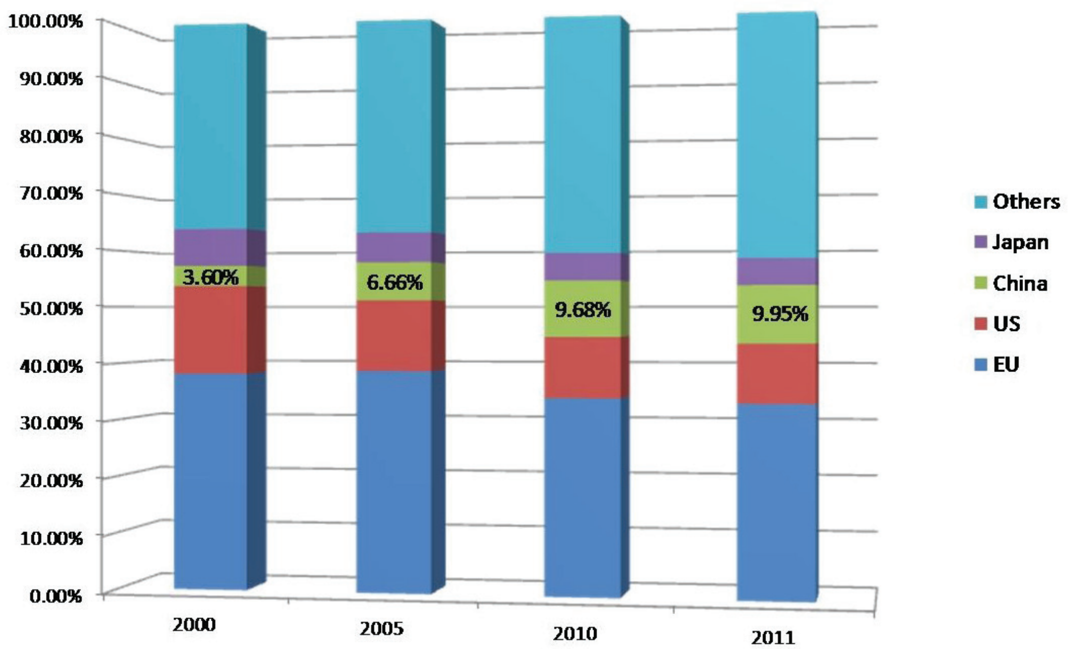
Lowering the Chinese economy's dependence on the dollar is part of a planned economic rebalancing away from over-reliance on exports towards generating home-grown growth based on enhancing living standards and domestic consumption – one of the principal components of the latest Five Year Plan.[18] Enhancing the renminbi's external role crucially requires the gradual removal of capital controls, enabling Chinese enterprises and households to invest abroad and opening the way to a much more efficient use of China's net foreign assets.[19] A fundamental consideration is to improve the return on Chinese savings. Emulating the 'exorbitant privilege' of the dollar, under which China can absorb capital inflows from abroad at a relatively low interest rate and reinvest these as productive foreign assets earning a much higher return[20], has become an aim espoused by many Chinese economists and academics. The Chinese authorities distinguish between means and ends. The overall aim is not attaining reserve currency status. Rather it is optimising China's economic power, resilience and prosperity. The internationalisation of the currency is a means to that end, and the chosen routes are through increasing the use of the currency in trade and investment between China and the rest of the world, and the opening up of a carefully-controlled offshore renminbi market to facilitate that aim.[21] As many experts have pointed out, this is a totally different route compared with those by which the UK and the US acquired reserve currency status, although it does bear some resemblance to the D-Mark's build-up in official reserves in the 1970s and 1980s.[22]

Chart 7: China's share of world GDP



Source: : People's Bank of China

Chart 8: China's share of world trade



Source: : People's Bank of China

Chapter Three

Gold and Chinese reserves

Amid pressures for significant change in the momentary system, China remains bound to the dollar, albeit with a modified peg. But an overhauling of China's financial linkages with the rest of the world coincides with important clues on the role of gold from China's own reserve asset policies. As the country which is now the world's top gold producer and vies with India for the No. 1 position in demand for jewellery and investment, China has been building up monetary stocks of the metal as part of diversification away from dependence on the dollar.

According to the World Gold Council, China roughly doubled its gold reserves between 2007and 2012, with holdings of 1,054 tonnes in July 2012, making up 1.6% of total Chinese foreign reserves. China is the world's sixth largest holder of monetary gold, but the proportion of gold in relation to total foreign reserves is very low compared with that of the largest holders – 1.6% compared with 75% for the US, and 71% for Germany, Italy and France (Table 2).

The true volume of Chinese reserves is subject to some uncertainty. There are indications that the real level is appreciably higher than reported.[23] China is clearly proceeding cautiously both in its overall strategy and in its communication policies over gold purchases. The authorities may wish to avoid disturbing markets by making premature announcements. In line with the overall policy of promoting a more balanced spread of the country's investments, China is also encouraging banks and individuals to own gold rather than the state. In general, though, at a time of question marks over sovereign debt, building up a stock of an asset that is no one's liability, ready to cushion the effect of a possible abolition of the (modified) dollar peg, would make sense.

On past patterns, China may announce a rise in gold reserves, as a result of accumulation over a reasonably long period, at a time that makes sense for the Chinese authorities. This points to a possible announcement at some time in the future when the gold price may be unambiguously rising. This could have a dual benefit for Beijing. Formal confirmation of Chinese gold-buying interest would indicate the investment acumen of China's foreign asset managers. In addition, it could influence other investment managers to emulate these policies.

Interlinked decision-making processes

An international consensus would be needed to bring the renminbi into the IMF's composite international currency unit, the Special Drawing Right.

Achieving Chinese aims on renminbi internationalisation requires a set of separate but interlinked decision-making processes – on increasing the renminbi's use in international trade and finance, on easing capital controls regulating Chinese inflows and outflows, and on building up the renminbi's share of global official reserve assets. In these different fields, China has only limited ability to act by itself.

China can independently push through improvements on internationalisation and capital account liberalisation. It can also make further steps towards de-pegging from the dollar, which would be a crucial condition for full reserve currency status. Yet it will need the acceptance of the world financial community if it is to become the world's No. 2 reserve currency after the dollar. In view of their prime requirement for liquidity, the world's premier central banks will not hold extensive volumes of a currency in their reserves that is not fully convertible.

An international consensus would be needed, too, to bring the renminbi (and other emerging market currencies) into the International Monetary Fund's composite international currency unit, the Special Drawing Right (SDR).[24] This idea was floated by Zhou Xiaochuan, governor of the People's Bank of China, in a well-publicised statement in March 2009, when he called for the SDR to develop into a 'super-sovereign reserve currency…that is disconnected from individual nations and is able to remain stable in the long run'.[25] However the IMF made clear in 2010 that it rules out bringing the renminbi into the SDR basket on the grounds of the currency's limited convertibility.[26] In 2011 France under President Nicolas Sarkozy made some efforts to lead a move towards reforming the international monetary reserve system, but these soon faded in view of the lack of interest by the US and other leading developed economies – as well as the more pressing need to tackle the euro crisis.

Instead of the somewhat unrealistic 'grand vision' earlier espoused by Governor Zhou, progress in 2011-12 towards a better international currency balance has been gradual and piecemeal. Within a system where controls on capital exports and imports are slowly being relaxed, the workings of the financial markets seem to have brought China's overall foreign exchange environment into a position of greater equilibrium. After six years of gradual appreciation against the dollar – amounting to 30% in nominal terms since 2005, as part of China's modification of the currency peg – the renminbi no longer seems fundamentally undervalued against the dollar.[27]

Amid repeated warnings from Chinese officials, academics and currency market specialists that predictions of a continued renminbi appreciation are no longer valid, the Chinese currency in 2012 weakened slightly against the dollar. Massive accruals of foreign exchange reserves have tailed off, in line with China's own perception that official reserves total of more than $3tn has been excessive.[28] China's overall current account position is in much better balance than earlier in the 2000s, with the current account surplus as a proportion of GDP substantially below that of Germany and other surplus countries in Europe.[29]

Chapter Three

Essentially, China is aiming for a system under which barriers between pools of renminbi on onshore and offshore markets are slowly dismantled. The renminbi will circulate with steadily greater freedom on foreign banking and financial markets and will be used in larger volumes and in a greater variety of international transactions. The growth of renminbi financial markets, in size, depth and sophistication, should help the overall development and sustainability of the Chinese economy.

The growth of renminbi financial markets, in size, depth and sophistication, should help the overall development and sustainability of the Chinese economy.

A further positive effect for China is that this trend should enable Chinese banks and financial institutions to build up potentially lucrative capital market activities for national and foreign clients, whether they be governments, corporations or private individuals. This would shield the banks from the deleterious consequences on their profitability of progressive liberalisation of domestic arrangements for setting interest rates. Under a less regulated system where Chinese savers are able to move money abroad, the banks will eventually have to pay more for deposits. Additional capital market business could provide a useful source of compensation for ensuing loss of profits.

Programme for renminbi internationalisation

In February 2012, China outlined a three-phase route map for full renminbi internationalisation over the next 10 years. If implemented, this would amount to a new framework for China's financial interactions with the rest of the world.[30] This was not a 'grand plan', rather a cautiously-worded proposal that emphasised China would not take a 'Big Bang' approach to internationalisation but would proceed in small, potentially reversible steps.[31] Beijing's prime consideration is that risks are maintained under careful review, that the thrust of any policy change unambiguously supports the aim of sustaining China's domestic economy and living standards, and that nothing is undertaken that could threaten the Party's hold on power. The Communist Party leadership is well aware that loss of monetary control was one of the reasons for the progressive weakening of the former Nationalist regime that led to the Communist takeover in 1949.

China will not take a 'Big Bang' approach to internationalisation but will proceed in small, potentially reversible steps.

One reason why the Chinese authorities will be proceeding with caution is that renminbi internationalisation has already had some unexpected effects. Chinese monetary officials' initial expectation was that the greater use of renminbi in trade invoicing would lower inflows of foreign exchange. In fact, reflecting the growing offshore renminbi market, domestic enterprises and individuals have become more sensitive to price signals such as exchange rates and interest rates, both onshore and offshore, leading to greater fluctuations in inflows and outflows in 2011-12 than previously.[32]

After having intially reacted guardedly to London's efforts to build up offshore centre renminbi activities, the Chinese authorities now seem to regard several vibrant offshore centres as a source of useful competition.

Under the timetable outlined in February 2012, the first phase, over three years, would open the way for more Chinese investment abroad. This would partly make use of a fall in activities by western banks and investment houses, seen as presenting a 'strategic opportunity' for China to move on to western markets. The second phase, in three to five years, would accelerate foreign lending of renminbi – a trend already seen through an increase in offshore borrowing in renminbi by western banks and corporations through transactions in Hong Kong, Singapore and London, and through programmes (concentrated on emerging markets) of the China Development Bank. After having initially reacted somewhat guardedly to London's efforts to build up offshore renminbi activities, the Chinese authorities now seem to regard several vibrant offshore centres as a source of useful competition as well as helpful complementarity (Table 3). The third phase, over five to 10 years, would allow foreigners to invest in Chinese stocks, bonds and property. Free convertibility of the renminbi would occur as 'the last step' at some unspecified time.

Leading Chinese officials speak of the long lags in the world monetary system that will maintain the dollar's supremacy in world monetary affairs despite the rapid rise of the Chinese economy.[33] Renminbi internationalisation has a lot of ground to make up. The dollar's share in international foreign exchange market turnover is 85%, with the renminbi accounting for just 0.9%.[34] Despite the rising use of renminbi in offshore bond transactions, centred on Hong Kong, these account for only 2% of total international bond issuance.

Table 3: Emerging renminbi offshore markets

Hong Kong	The largest renminbi offshore centre with many products
Singapore	Renminbi NDF was emerged in 1996, renminbi deposits
London	Larger than expected in terms of deposits, spot trading
Tokyo	NDF, Recently introduced renminbi-yen direct trading
Chicago	Launched renminbi NDF in 2006
Taiwan	New agreement on renminbi settlement, potential is large

Source: People's Bank of China

Note: NDF - Non-deliverable Forward Contracts

Leading role for trade invoicing and settlement

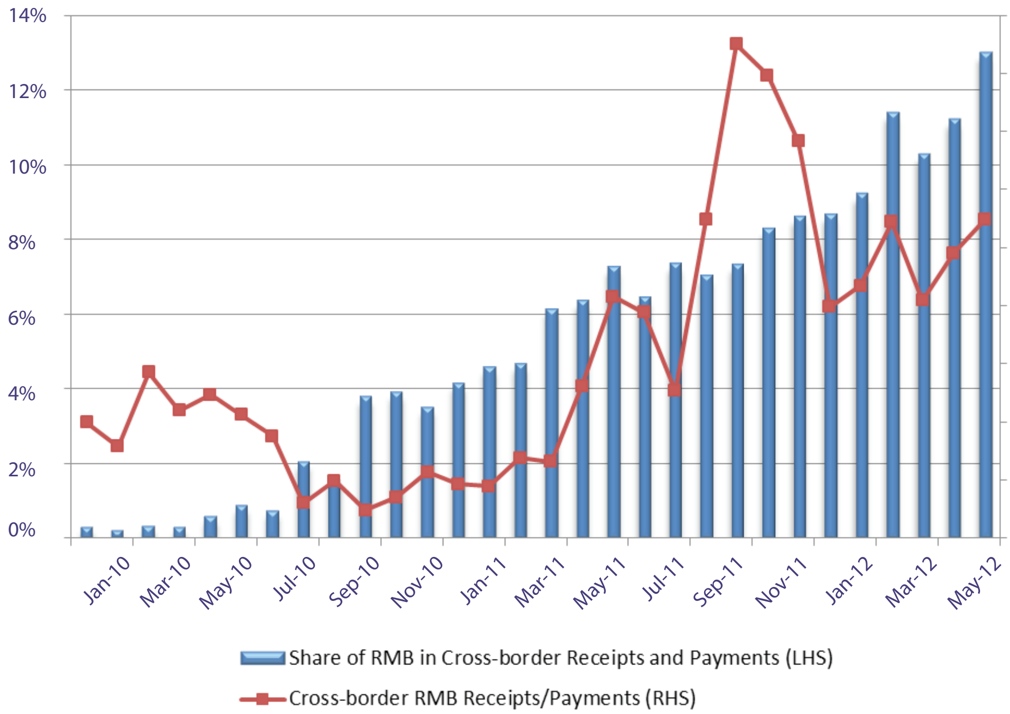
Progress in the renminbi's international use has been concentrated on trade invoicing and settlement. In the first half of 2012, the renminbi's share of China's overall cross-border receipts and payments stood at around 11%, up from around 7% in 2011, and only 2% in 2010 (Chart 9). Renminbi flows into China for foreign direct and portfolio investment increased threefold compared with a year earlier. The authorities have built up a renminbi clearing agreement between Hong Kong and the mainland to reflect the growing pace of economic integration and de facto renminbi convertibility between these two areas. This has accompanied a sharp increase in volumes of renminbi held and traded in Hong Kong, although the amounts levelled off during the latter part of 2012 (Chart 10).[35]

The Swiss National Bank has moved reserves into both the Korean won and the Singapore dollar but has refrained from investing in renminbi.

The People's Bank of China has signed renminbi swap agreements with 18 foreign central banks – including Japan, South Korea, Hong Kong, Singapore, Iceland, Argentina and Australia – to provide Chinese currency liquidity to local markets abroad (Table 4). Between 10 and 15 central banks own mainly small volumes of renminbi reserves through agreements with the People's Bank. Most of the reserve-holding is concentrated on Asia.[36] According to the PBoC holdings also extend to Africa, Latin America, Europe and Middle East. Notable non-Asian central banks to hold renminbi reserves include the Central Bank of Nigeria (where the governor announced in 2011 that 10% of reserves would be eventually held in renminbi)[37] and the Austrian National Bank (the first European central bank to invest in the Chinese currency).[38]

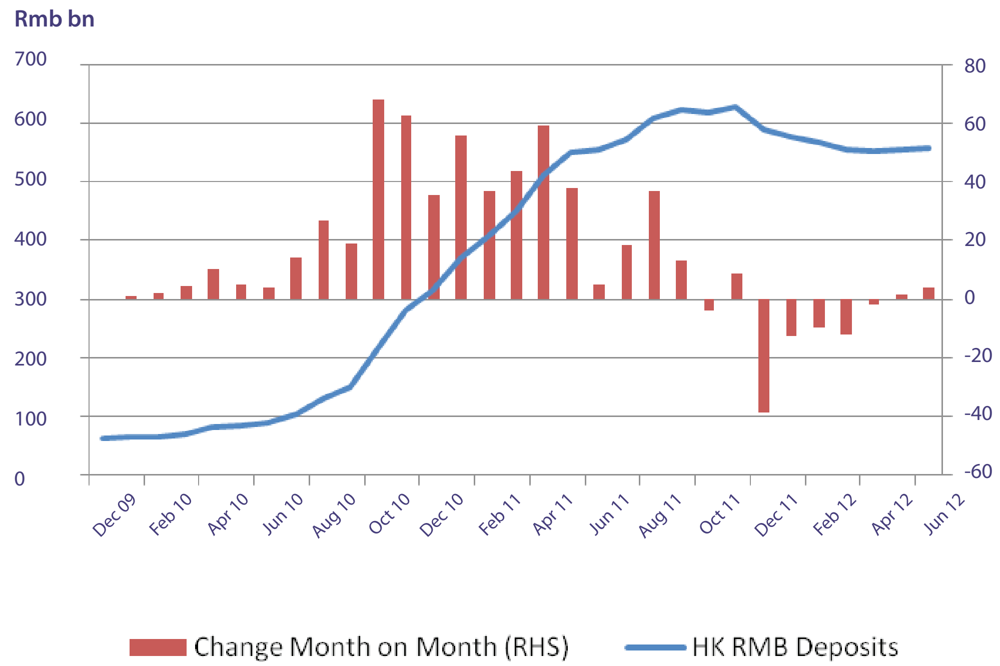
Other leading European central banks have made clear that they will not contemplate renminbi ownership until the currency is fully convertible. Notably, the Swiss National Bank, which has emerged as the most diversified reserve holder in Europe as a result of large-scale intervention to hold down the Swiss franc against the euro, has moved reserves into both the Korean won and the Singapore dollar but has refrained from investing in renminbi.[39]

Chart 9: Share of renminbi in cross-border receipts and payments



Source: State Administration of Foreign Exchange (SAFE)

Chart 10: Hong Kong renminbi deposits



Source: State Administration of Foreign Exchange (SAFE)

Table 4: Renminbi bilateral central bank swap agreements

Country/ region	*Date*	*Amount (Rmb bn)*
Bank of Indonesia	23.03.2009	100.0
Central Bank of Argentina	23.03.2009	70.0
National Bank of the Republic of Belarus	24.03.2010	Agreement on bilateral settlement in local agencies
	11.03.2009	20.0
Central Bank of Iceland	09.06.2010	3.5
Monetary Authority of Singapore	23.07.2010	150.0
New Zealand Reserve Bank	18.04.2011	25.0
Central Bank of the Republic of Uzbekistan	19.04.2011	0.7
National Bank of Kazakhstan	13.06.2011	7.0
Bank of Korea	26.10.2011	360.0
	12.12.2008	180.0
	(Expired)	
Hong Kong Monetary Authority	22.11.2011	400.0
	20.01.2009	200.0
	(Expired)	
Bank of Thailand	22.12.2011	
State Bank of Pakistan	23.12.2011	10.0
Central Bank of the United Arab Emirates	17.01.2012	35.0
Bank Negara Malaysia	08.02.2012	180.0
	08.02.2009	80.0
	(Expired)	
Turkish Central Bank	21.02.2012	10.0
Central Bank of Mongolia	21.03.2012	10.0
	06.05.2011	5.0
	(Expired)	
Reserve Bank of Australia	22.03.2012	200.0
Central Bank of Ukraine	26.06.2012	15.0

Sources: People's Bank of China

Future areas for renminbi expansion

In view of the widespread perception that the Chinese authorities are covertly building up gold reserves, Beijing can hardly take a completely neutral position on gold policies.

The Chinese authorities may be prepared to make use of a number of opportunities to expand international use of the renminbi in a way that goes beyond invoicing and settlement for trade and investment. One idea put forward by Chinese economists with close links to the authorities is that China should encourage both its own borrowing entities as well as indebted western nations to issue bonds in renminbi specifically destined to be held in foreign countries official reserves. (If that were the case, China would have to proceed to full renminbi convertibility.)

China seems likely, too, to encourage moving pricing of some internationally-traded energy products and commodities into the renminbi. This would promote use of a renminbi standard for both hedging and borrowing transactions and, over time, would lead to both exporting and importing countries using renminbi in their reserves. In particular, the Chinese authorities have shown evident interest in promoting renminbi pricing for gold in Hong Kong and on international markets.[40]

An important role will be played by the Chinese authorities' overriding policy of announcements regarding gold. In view of the traditional popularity of the domestic gold market for private citizens, and the widespread perception that the Chinese authorities are covertly building up gold reserves, Beijing can hardly take a completely neutral position on gold policies. On the other hand, any overt Chinese declaration on the central role of gold would automatically damp Chinese people's faith in fiat currencies and could promote an unhealthy over-interest in the metal, with negative effects on the country's stability. For these rather complex reasons, the Chinese government's official gold stance is likely to remain rather non-committal.

Chapter Four

4 The next five years: outlook 2013-18

Medium-term scenarios for world growth, currencies and gold

This chapter attempts to outline a number of scenarios for medium-term global economic developments. It focuses on developments in the US, the euro area and China. There are many more possible permutations than those expressed here; although the four scenarios we show are in our view the most likely ones, we are not attempting to rank them in order of probability. The aim is not to attempt to forecast the world economy, but to show how and why different outcomes would affect currencies and the relative attractiveness of gold.

SCENARIO ONE: RECOVERY

This scenario assumes that the Fed successfully implements further quantitative easing following the announcement of so-called QE3 in September 2012. In addition, it assumes that US politicians manage to reach agreement on fiscal reform and rebalances US public sector finances, which then benefit from stronger output growth. The euro area successfully holds together, causing the euro eventually to strengthen. China shifts from its investment- and export-dependent growth model to a more stable but somewhat lower trend growth rate based on domestic demand.

Macroeconomic developments	*Currency effect*	*Impact on gold*
Fed implements further easing. US overcomes fiscal cliff. US economy moves to 2.5% growth or higher.	Initial dollar weakness from Fed policy is followed by dollar strength thanks to attractive US economy.	Broadly neutral: weaker dollar is positive for gold, but as dollar recovers owing to stronger US growth, the attraction of gold diminishes.
Euro area works through its problems and survives intact.	Euro strengthens as Europe appears to have overcome the crisis.	'Safe haven' appeal of gold falls.
China successfully adjusts to 5-7% trend growth.	Renminbi internationalisation remains on track.	Chinese continue to buy gold. Emerging market central banks continue opportunistically to build up gold reserves.

SCENARIO TWO: WORRY I

This scenario assumes that, following the Fed's QE3, further monetary policy stimulus is postponed due to conflicting economic signals and the US political cycle. Any benefits are therefore delayed. In the euro area, the crisis intensifies with one country, possibly two, leaving. China attempts to stimulate domestic demand, but the impact is muted, partly because the stimulus is smaller than in 2009, partly because weaker global growth means exports are not strong enough to provide much help, and investment growth therefore weakens. In this scenario, the Chinese authorities move faster to further de-peg the renminbi from the (strengthening) dollar in order to avoid the currency strengthening against the euro.

Macroeconomic developments	*Currency effect*	*Impact on gold*
US economy grows enough to delay further monetary stimulus, but trend growth is only 2%.	Dollar strengthens, less because of its own appeal, more because the euro weakens.	Positive, because of general uncertainty and gold's appeal as a euro hedge.
Euro area crisis intensifies.	Euro drops sharply.	Gold's attractiveness rises as a means of diversifying and hedging against euro exit. Central bank buying resumes even at higher prices.
China tries to stimulate domestic demand.	Renminbi decouples from dollar as further de-pegging is seen as attractive.	Chinese buying continues.

SCENARIO THREE: WORRY II

This is similar to Scenario Two, with one key difference. The Chinese authorities fail to understand the depth of the weakness of their economy and/or their stimulus measures have no effect. As a result, the Chinese economy suffers a hard landing – entailing not just weaker output growth, but, potentially, a recession with GDP contracting. Economic weakness spurs further renminbi-dollar de-pegging as Beijing believes the dollar will strengthen so the renminbi needs to weaken to boost the competitiveness of Chinese exports. A continued export-led growth strategy leads the Chinese authorities to seek to keep the exchange rate as low as possible, resulting in a further build-up of Chinese foreign exchange reserves following the 2011-2012 lull.

Macroeconomic developments	*Currency effect*	*Impact on gold*
US economy grows enough to delay further monetary stimulus, but trend growth is only 2%.	Dollar strengthens, less because of its own appeal, more because the euro weakens.	Positive, because of general uncertainty and gold's appeal as a euro hedge.
Euro area crisis intensifies.	Euro drops sharply.	Gold's attractiveness rises as a means of diversifying and hedging against euro exit.Central bank buying resumes even at higher prices.
China suffers recession, GDP contracting for at least two consecutive quarters.	Renminbi decouples from dollar, authorities attempt to depress currency.	Chinese private sector buys more gold to protect purchasing power.

SCENARIO FOUR: CRISIS

World growth slows sharply from 2013 onwards. US fiscal rebalancing is impeded by continued deadlock in Congress. US output growth weakens sharply, further impairing public finances. As the stand-off between debtors and creditors in the euro area intensifies, the European single currency breaks up, with legacy currencies reintroduced in a number of countries, and recession follows in a number of countries. Weak demand in the rest of the world leads to a Chinese recession.

Macroeconomic developments	*Currency effect*	*Impact on gold*
US economy in recession due to fiscal tightening. Public finances remain weak, as does domestic demand.	Dollar strengthens, as the least unattractive currency.	Neutral: Dollar strength is initially gold negative, but US weakness then boosts gold.
Euro area unravels. Recession in a number of countries.	Euro drops sharply. New D-Mark-like currency for German bloc strengthens, but others weaken.	Gold positive, as central banks re-adjust reserve holdings and investors react to euro upset. Central bank buying becomes more important. After euro break-up, Germany may be more ready to carry out gold sale to China.
China suffers recession, GDP contracting for at least two consecutive quarters.	Renminbi decouples from dollar, authorities attempt to depress currency.	Chinese continue to buy gold. Emerging market central banks continue opportunistically to build up gold stocks.

Summary of scenarios

The US remains the most resilient of the main world economies. Although some imbalances remain – notably on the fiscal side – the US has on the whole rebalanced more successfully than its competitors. One consequence is that most scenarios are dollar positive. This should lower the build-up of foreign reserves. If the dollar is strong, there is less need for other countries to attempt to depress their own currencies to achieve a competitive advantage.

In all these scenarios, China maintains a continued push for renminbi internationalisation, although the main reasons behind this will change according to the environment. Although a strong dollar is not normally a signal for a higher gold price, continued uncertainties over the euro and the world economy, and further moves towards a multi-currency reserve system, should enhance gold's appeal as a hedge against disruption caused by turbulence and transition.

Chapter Five

5 Future of gold in the international monetary system

For gold to play a greater role in the future, it has to become more actively traded, including by central banks.

OMFIF considers that the world is moving towards a (more or less) stable multi-reserve currency system, consisting of the dollar, the euro and the renminbi. The dollar will remain in the lead, but it will share its role with a greater number of other currencies. (In the event of a euro break-up, then the new currency that emerges as Europe's strongest, likely to be centred on Germany and countries with which it has close trading and investment relationships, will be used in international official reserves, just as the D-Mark was up to 1999.) The previous chapters have explored the role of reserve currencies, the scope for internationalisation of the renminbi and the role of gold in the transition from one reserve currency to another. This leads to six broad conclusions about gold's future role.

1. Gold will play a greater role in the future than today – but not a dominant one.

In an international monetary system with only one real reserve currency (the dollar), the role of gold has been limited. While some central banks in the past have held on to gold reserves for the purpose of having a 'final reserve', i.e. to be used in extremis to defend a currency or finance imports, this is unlikely to have been an appropriate use of resources. Where gold has had an important role, it has been seen as the ultimate safe haven, a hedge against geopolitical risk and, crucially, a hedge against the reserve currency (i.e. as a dollar hedge). In the future, that role may again come to the fore, in view of the uncertainties created by the renminbi's gradual rise to international prominence. The role of gold is likely to be bigger in the transition period to a multiple reserve currency system than when such a system is in existence; in both cases, it will be greater than today.

2. Central banks will trade gold more actively.

For gold to play a greater role in the future, it has to become more actively traded, including by central banks. These developments will to a certain extent become self-reinforcing; for gold to play a greater role it has to be traded more actively. But once gold is traded more actively, it ipso facto plays a greater role. Outright buying and selling will go hand in hand with a more widespread use of central bank gold in official borrowing and lending operations, also as collateral in some transactions, mirroring developments in the private sector.

3. Gold will not replace fiat currencies; the Gold Standard will not return.

Nostalgia for a supposed golden age of the Gold Standard, coupled with concerns about governments' ability to manipulate fiat currencies, occasionally gives rise to calls for, or predictions of, a return to gold as the underlying basis for the international monetary system. This is not possible. Gold's relative scarcity means that it could only ever replace a fiat currency on a fractional basis. Even that is unlikely, as a legacy of history.

The concentration of gold's ownership can be expected to move gradually from the industrialised west towards the emerging market economies.

4. Gold will increasingly become a currency hedge, not just a dollar hedge.

As the world moves towards a multi-currency system and as gold becomes de facto a part of that system, its special relationship with the dollar will wane. The current negative relationship with the dollar will spread to other reserve currencies, making it to some extent a hedge against all fiat currencies. Gold will retain the characteristic of being an asset without being somebody's liability. Furthermore, it is likely to remain a geopolitical hedge.

5. Rebalancing of gold in central bank reserves is likely.

The concentration of gold's ownership among official reserve holders can be expected to move gradually from the industrialised west towards the emerging market economies, especially in Asia. The Bundesbank, for example, has maintained gold reserves at a conspicuously stable level during the past decades, with its reluctance to sell gold partly reflecting differences of opinion with the German finance ministry over distributing the profits. If these differences were to be resolved, a move towards 'rebalancing' by the Bundesbank, for instance through selling gold directly to the People's Bank of China, would have widespread repercussions. Although the complexities of such agreements are very high, discussions on this type of arrangement may find their way on to the international agenda in coming years.

6. Greater attention will be paid to geographical location of central bank gold storage.

Large Chinese banks, which are actively building vault space as a means of underpinning the country's private sector gold activities, will increasingly offer storage facilities to central banks from developed and emerging market economies to offset the west's traditional dominance in this field. Diversification of physical gold holdings will be a side-effect of a more dispersed pattern for gold buying and selling by central banks around the world. In line with efforts to improve the tradability of gold in central bank vaults, central banks and other official institutions will pay attention to holding gold in areas where the metal can be used more readily as collateral and in other forms of transactions. Issues of convenience, reliability and cost will generate greater interest in central banks holding gold away from the traditional centres, mainly at the Federal Reserve Bank of New York and the Bank of England.

A Historical parallels: reserve currencies in the past

The lessons of history

The history of reserve currencies demonstrates important lessons for China. A reserve currency country undoubtedly wields power, but this goes hand in hand with considerable responsibilities and can expose it to major setbacks. It cannot be ruled out that the Chinese authorities have decided to build up gold reserves as a deliberate hedge against the possibility that the rise of the renminbi as an internationally significant currency will be neither linear nor problem-free. History suggests there may be a causal link between a likely increase in renminbi use as an international reserve currency in the next 10 years and a similar rise in the role of gold.

The only previous significant transition between reserve currencies – the ending of sterling's pivotal role in the 1960s – also saw an increase (albeit temporary) in gold's monetary use. Gold was accumulated in French reserves in a deliberate (yet ultimately unsuccessful) attack on the status of the dollar, and was sold by the British authorities to pay off earlier international balance of payments loans.[41] With monetary influence now spread among a much larger number of countries and institutions around the world, parallels with the past should not be taken too far. But the record suggests that an uncertain time of evolution from one reserve currency to another may encourage gold to advance in monetary usage.

The interplay of political and monetary influence is another lesson of history. Ever since money was first introduced, there have from time to time been dominant currencies. Their dominance has depended on the power of the issuer or on the reputation of the currency and its metal content. However, this use of currencies is different from what we mean by a reserve currency. Dominant currencies in past ages were used both for international trade, and also internally in preference to domestic currencies that were frequently debased or unreliable.[42]

A reserve currency in the modern sense of the word signifies a currency held as part of the foreign exchange reserves of central banks and other monetary authorities; a currency that is used in trade, not only with the issuing country but also among countries that do not include the issuer; and a currency that is used in official investment and financial transactions.[43] The existence of a reserve currency presupposes international trade between countries with different currencies. While there have historically been dominant currencies in east Asia, the area's traditionally larger contiguous empires and more limited international trade made the question of a reserve currency irrelevant until more modern times. From this perspective, there have only been two dominant reserve currencies, sterling from the late 18th Century until (somewhat arbitrarily) 1976; and the dollar since (again somewhat arbitrarily) the end of the First World War.

While the dollar and sterling coexisted as major reserve currencies for a lengthy period, they were never truly 'equal'. Rather, sterling declined constantly in importance, reflected in major events such as Britain's departure from the Gold Standard in 1931, the Second World War, the run on sterling when convertibility was briefly restored in 1947, the American-led assault on sterling in the wake of the Suez Crisis in 1956, the devaluation in 1967 and the British government's request for IMF support in 1976. This was mirrored by the rise in the importance of the dollar, surviving the breakdown of the Bretton Woods system in the early 1970s. Sterling's history, especially its tortuous decline, does not provide a propitious precedent for a stable, multi-currency reserve system.

The early international monetary system

In the sense that central banks also held gold, gold was also a reserve currency. However, it should be noted that for the first of the past two centuries, the bulk of gold was not held by central banks but was in private hands. If a country was on the Gold Standard, much of the country's gold would circulate in the form of coin. As an example, the Bank of England held £10m worth of gold in its reserves in 1857; but the stock of gold coins in circulation was worth up to £50m.[44] It was only after the First World War, when the Gold Standard de facto had been replaced by the Gold Exchange Standard, that central banks held more financial gold than the private sector.

If we date the beginning of the 'reserve currency era' to the aftermath of the Napoleonic Wars, the international monetary system was, by modern standards, relatively straightforward. Only one major country, the UK, was on the Gold Standard, while the US was on a bi-metallic standard. Other countries were generally on silver or even on paper standards.[45] The limited amount of gold in existence is shown by the fact that the Bank of England tended to have gold reserves of between 50 and 100 tonnes and occasionally considerably less, with the only other major central banks of the time, the Banque de France and the Swedish Riksbank, holding less than 10 tonnes.

The gold discoveries in North Carolina in the 1830s, California in the 1840s and Australia in the 1850s, enabled other countries to move towards the Gold Standard. Demand for gold eventually outstripped supply (notably after the US returned to gold in 1873 after its civil war-induced hiatus), causing a major deflation from 1873 to 1896 – the original 'Great Depression'.[46] This was then alleviated by further gold finds in South Africa and Alaska. By 1914, most major economies were on the Gold Standard, only to go off gold during the First World War. Throughout this period, gold and the pound sterling were the main reserve assets.

By 1870, the size of the US economy outstripped Britain's, marking the arrival of another key actor in the international arena.[47] By 1912, the US had overtaken the UK in terms of exports.[48] However, the US was still dependent on the UK for trade finance. This was partly because the US did not have a central bank; but that changed with the establishment of the Federal Reserve in 1913. The dollar did not make its international debut until after the First World War, but already during the conflict, the pound suffered a first blow when (in 1916) the British government pegged its value to the dollar. The peg required American support; when that disappeared after the end of the war, sterling's value promptly fell by one-third.

Sterling's travails

The 1920s saw the first clear challenge to sterling. Benjamin Strong, President of the Federal Reserve Bank of New York, pursued a deliberate policy aimed at wresting dominance away from London, notably by getting countries in trouble to source their stabilisation loans in New York. This policy was successful – by 1925 the dollar had replaced sterling as the dominant international unit – but it also brought problems. The rush to ensure that international bond loans were emitted in New York, rather than in London, led to laxer standards and (unsurprisingly) the appearance of lower-quality bonds. This is a key point for the Chinese authorities to bear in mind. If they want the renminbi to become a world reserve currency, they will have to ensure greater use of the currency. But they must also ensure robust standards for that use, as a means of maintaining confidence in the currency.

The next blow to sterling came when the currency was forced off the gold standard in September 1931. However, this was not followed by a rise in the dollar. On the contrary, the immediate market reaction was that other countries – including the dollar – would follow the British move. Instead, the result was a surge in the gold price. There was a similar development after the British devaluation in 1967, which was followed by a run on the dollar as a result of market perception that both reserve currencies of the Bretton Woods system were under threat.

Britain's decision to 'go off gold' accelerated a diminishing role for bullion in the world monetary system. As early as 1922 it was clear that there was not enough gold to finance the growing volumes of world trade. Moreover, by 1925, the US already held 45% of all financial gold stock.[49] Holding dollars thus became de facto equivalent to holding gold, and the world, no longer on a Gold Standard, was on a Gold Exchange Standard, where gold was no longer in daily use but remained the ultimate international monetary anchor. The main factor holding back the dollar from dominating the world economy between the wars was political rather than economic: American unwillingness to assume the burden of world leader. Similarly, the present Chinese leadership is aware of the possible drawbacks from the renminbi's development as a reserve currency – e.g. the need to run a current account deficit, the loss of control over the exchange rate and so on. Statements from Chinese financial leaders show recognition of the dangers of enacting a reserve currency policy too quickly.[50]

Political economy to the fore

The political economy of reserve currency status was again on display after the Second World War. The US economy became by far the largest in the world; but the US was under threat from a new implacable foe in the form of the Soviet Union. Meanwhile, Britain was exhausted. To rely on others to lead the world, while reaping the benefits, was no longer an option. The primacy of the dollar was clearly recognised in the Bretton Woods system, with currencies pegged to the dollar, and the dollar pegged to gold.

Sterling remained an important reserve currency. But two-thirds of sterling claims were held by the sterling area (primarily the British Empire and Commonwealth). These were not necessarily willing holders of sterling. When sterling convertibility, under American pressure, was restored in 1947, sterling holders rushed to convert their holdings to dollars. Controls were quickly re-imposed and maintained until 1959.[51]

As sterling lurched from weakness to weakness, the dollar's supremacy seemed unchallenged. From time to time, though, other currencies rose up in the wings. The French franc had some historical claim to reserve currency status, while both the D-Mark and the yen became candidates as reserve currencies on account of their revitalised economies and strong export growth. In each case, however, there were obstacles. Germany lacked open and deep financial markets and was in any case wary of pursuing reserve currency status, on the grounds that a D-Mark substantially traded and held outside the country could expose it to great political and economic problems. France lacked fundamental financial stability.

As for Japan, there were geopolitical issues – memories of the Second World War – that militated against willingness by Asian or European economies to use the yen. In a parallel to current Chinese attitudes, both the German and the Japanese authorities were reluctant to see their currencies take on full-blown reserve currency status on the grounds that this might subject them to strong upwards pressure that that would have negated their export-led growth strategies.

So, in spite of the breakdown of the Bretton Woods system in the early 1970s, the dollar has remained by far the world's dominant reserve currency. Periodic talk about its toppling and replacement by other currencies or by artificial units like the IMF's Special Drawing Rights (SDR) has not been borne out by reality.

One motivation behind the creation of the euro was that it should become a reserve currency to rival the dollar. But in view of the travails attending the euro, that objective seems highly unlikely to be realised. The anticipated development of the renminbi has to be measured against the past vicissitudes of reserve currencies. There is no guarantee that the dollar will remain paramount. But becoming a successful reserve currency requires more than political ambition, economic size and geopolitical clout. The path to reserve currency status is not an easy one. And the goal, once achieved, may be less attractive than it seemed. For the renminbi, this is a cautionary tale.

There has never been a stable period of equal reserve currencies. The only shift from one dominant reserve currency to another took around 60 years. History shows that the fall in the value of one reserve currency does not necessarily translate into a rise in the value of others. Instead, turbulence for one reserve currency may well spell turbulence for all, prompting markets to seek a non-currency safe haven. The answer, usually, is gold.

B The evolution of official reserves since the1990s

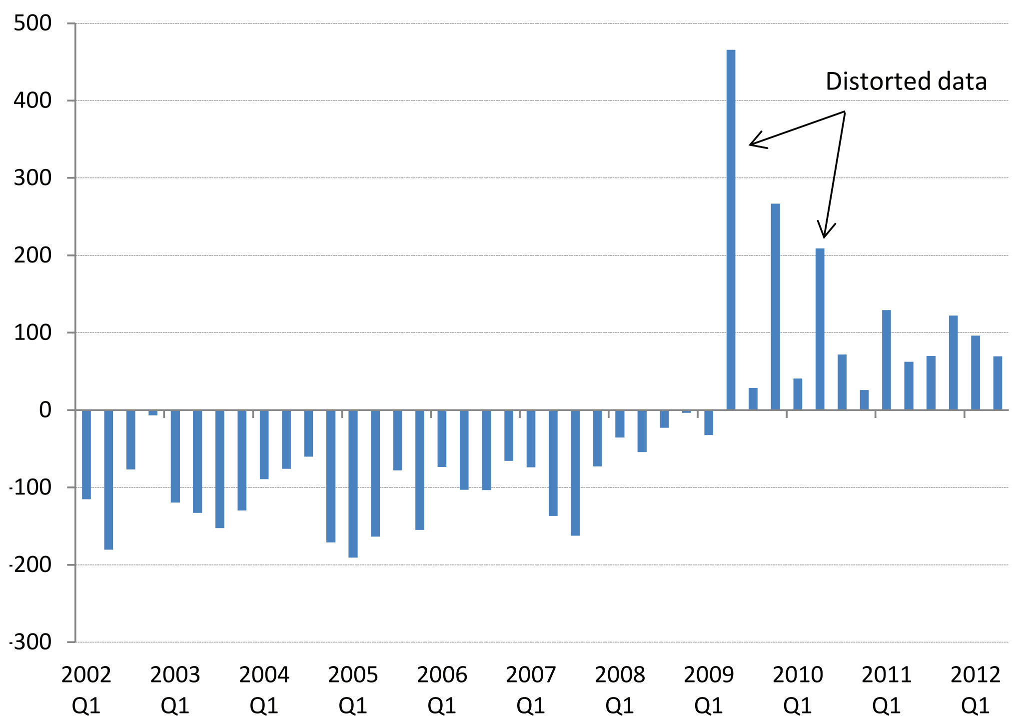
Although foreign exchange reserves have increased substantially since the late 1990s, the composition of reserves has changed less, based on the IMF figures for 'allocated' reserves. Changes in gold holdings have been more significant, even more so since the financial crisis. From Q4 2007 to Q1 2012, total holdings rose by 4.3% or 1,286 tonnes (Chart 11). This number needs some explanation. Gold purchase data shows central banks buying some 100 tonnes net in 2010 and another 400 tonnes net in 2011. The 1,286 tonnes include Chinese and Saudi numbers which should have been spread over a number of years prior to the date when they were announced. Crucially, over this period, central banks, which had been net sellers of gold for decades, turned into net buyers in 2010, increasing their purchases in 2011.

Within this total there were substantial variations. In relative terms, the largest increases took place in Mexico, Bangladesh and South Korea. In total, 20 central banks increased their gold holdings by more than 10%; while 17 reduced their holdings by 10% or more (Chart 11; this excludes countries with minimal changes which may be due to accounting or rounding errors).

Looking instead at the absolute changes in gold holdings (Chart 13), the biggest buyers over the period since the transatlantic financial crisis have been China (454 tonnes), and Russia (445 tonnes). In addition, India, Saudi Arabia, Mexico, Turkey, Thailand and Philippines all added more than 50 tonnes to their reserves. By contrast, seven holders (including the IMF) disposed of more than 50 tonnes over the period.

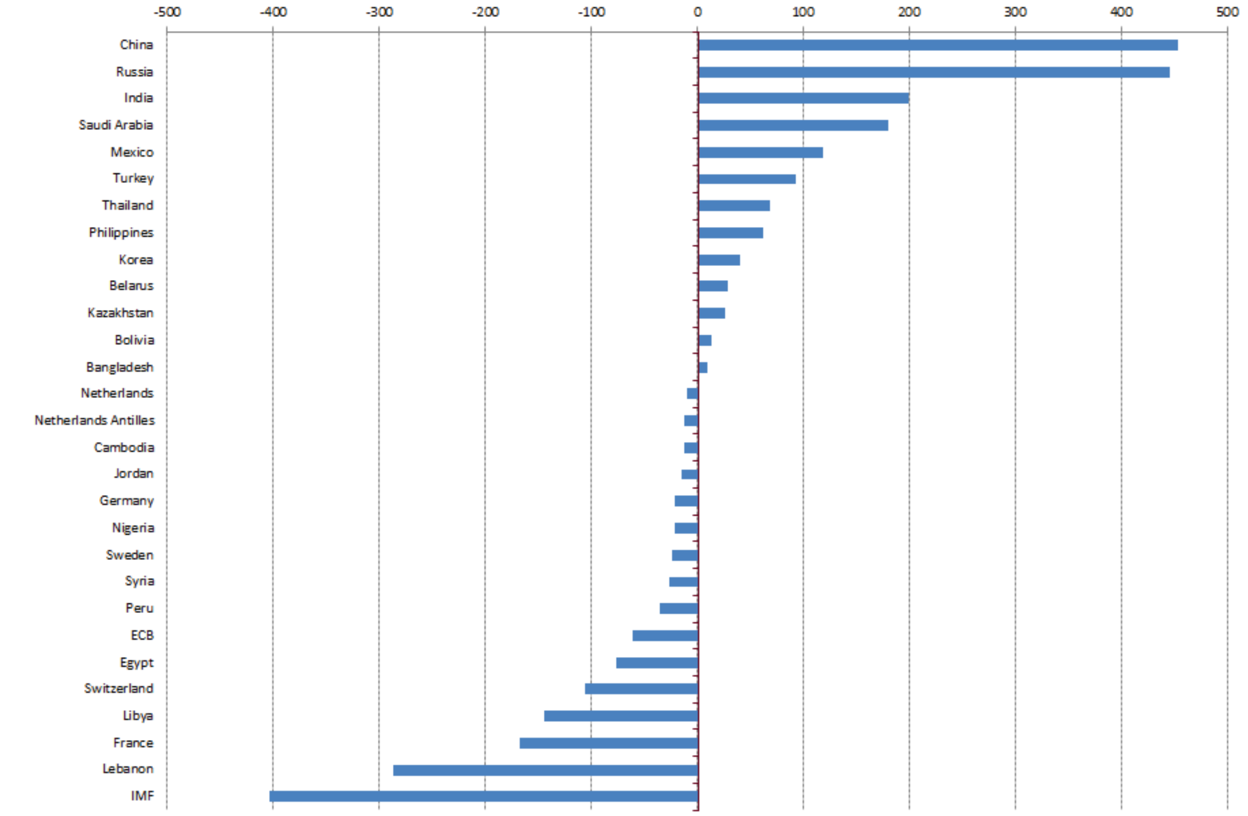
Chart 11 and Chart 12 show that out of a total of 124 official institutions reporting, 48 (i.e. around 40%) have significantly changed their gold holdings, in either direction, over the past four and a half years.

Chart 11: Official sector net purchases of gold by quarter, tonnes



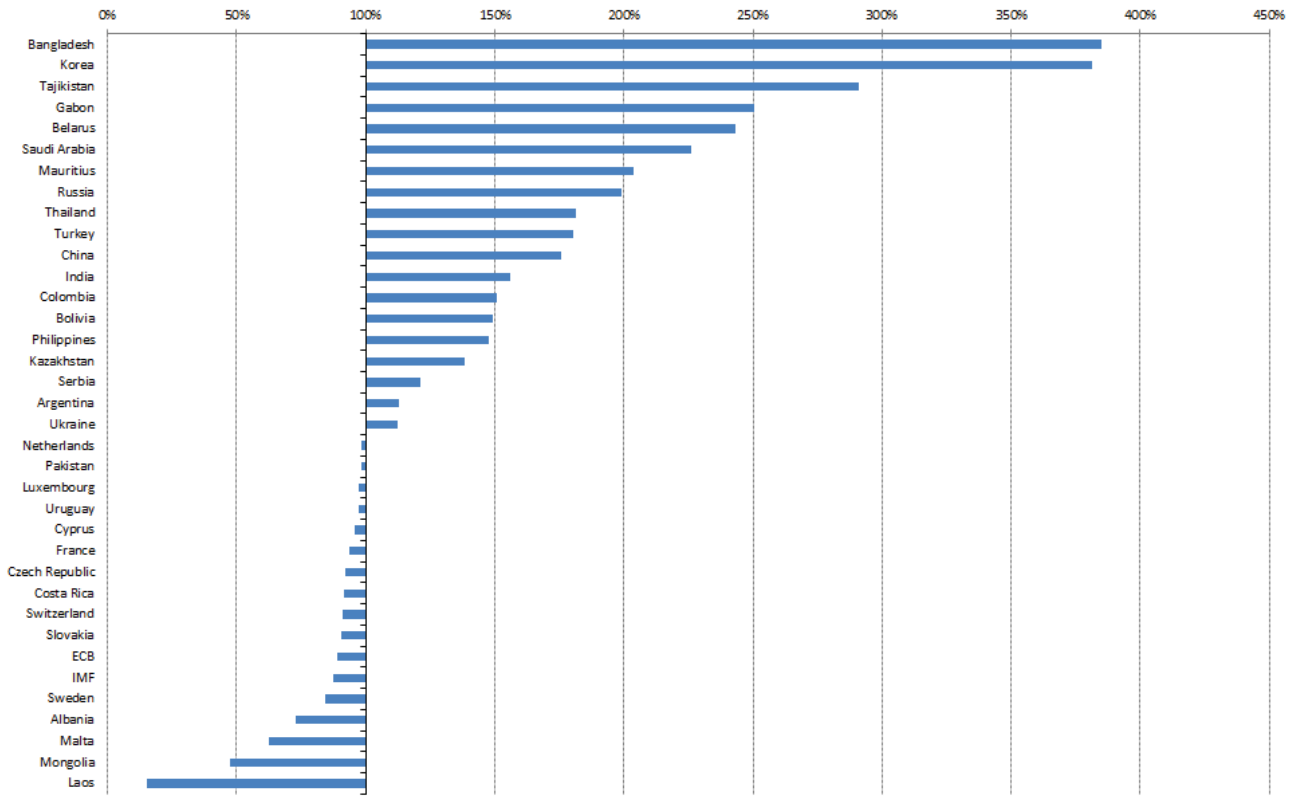
Source: World Gold Council
***NB** Data for 2009 Q2 and 2012 Q2 distorted*

Chart 12: Changes in gold holdings (% change in tonnes) by central banks and official bodies, Q4 2007 - Q1 2012



Source: World Gold Council
Note: Mexican holdings rose by 3,321%; this is excluded from the table as it would distort the other numbers

Chart 13: Changes in gold holdings (changes in tonnes) by central banks, Q4 2007 - Q1 2012



Source: : World Gold Council
Note: Only changes in excess of 10 tonnes shown

Notes

1. The phrase 'exorbitant privilege' was first used in an article in Le Figaro the 1960s by Valéry Giscard d'Estaing, French economics and finance minister under President Charles de Gaulle. See David Marsh, 'The Euro – The Battle for the New Global Currency', p. 49.
2. By contrast, US policy-makers regularly opine that reserve currency status brings great responsibilities and burdens too – especially when this role is in decline or under threat, as witnessed by Britain in the 1960s and 1970s during the run-down in sterling's position as an international currency.
3. Inflation, in order to work, has to come by surprise and constantly remain higher than expected. For this to happen, we have to assume that markets would accept this for a number of years without pushing up bond yields. It also assumes that central bankers, with mandated inflation targets, would consciously conspire to break the law and face the consequences. Finally, inflation does wipe out debt, but only by wiping out the value of assets as well. That is unlikely to be politically acceptable, particularly in ageing societies.
4. IMF Composition of Foreign Exchange Reserves (COFER).
5. The dollar's decreasing share in foreign exchange reserves in the early 2000s is partly linked to the appearance of the euro. As a significant potential world reserve currency, the euro was more attractive than the euro legacy currencies (D-Mark, French franc etc). On the other hand, once the euro was created, euro area countries' holdings of each other's currencies no longer qualified as foreign exchange reserves, which would tend to increase the share of the dollar.
6. The quarterly figures published by the IMF have become a less reliable source of information on reserve composition. Several countries do not give the IMF data on the make-up of their reserves, reflected in the rising share of 'non-allocated' reserves. This portion has risen to around $4tn, around 45% of the total in 2011 against 25% of a much smaller number in 1995, primarily because China does not provide the IMF with a breakdown of its holdings. While this clearly introduces a distortion in the data, it is not clear that this will in any significant way affect the breakdown of reserves by currency.
7. IMF statistics, IMF website.
8. IMF COFER since 1995, IMF International Report 1997, Appendix 1 for pre-1995 data.
9. Once the euro was formed, euro area countries could no longer hold each other's currencies as foreign exchange reserves. Hence the introduction of the euro initially gave a small boost to the dollar's reserve share. This was later balanced by the greater attraction of the euro than pre-euro currencies such as the D-Mark or the French franc.
10. China Securities Journal, September 2010, citing unnamed reserve managers, said 65% of China's reserves were in dollars, 26% in euro, 5% in sterling and 3% in yen. Since the Journal is an official newspaper, this was an authoritative view of Chinese holdings.
11. There would, though, be a countervailing effect: action to sell dollars would boost the value of the renminbi, which, in turn, should strengthen domestic demand, a goal of Chinese policy.
12. According to research from Royal Bank of Scotland, the optimal allocation of gold in an emerging central bank's foreign exchange reserves is between 8.4% and 10%. 'RBS Reserve Management Trends, 2012: Optimal gold allocation for emerging-market central banks'.
13. The Swedish Riksbank, for example, has announced that it intends to hold a range of securities of different maturities to be able to, if necessary, intervene in financial markets. So it is not just gold and other currencies that are likely to play a bigger role, but other assets as well (although these are not all foreign exchange reserves).
14. World Gold Council statistics.
15. Ibid.
16. This presupposes that central banks will not wish to take part in a 'bidding war' with private investors. Currency considerations are, however, important. For many central banks, buying gold even when seemingly expensive in dollars may still be profitable, namely if the domestic currency depreciates against the dollar. For many emerging market economies in recent years, however, the opposite has been the case.
17. 'The Renminbi's Role in the Global Monetary System', Eswar Prasad and Lei (Sandy) Ye, Brookings, February 2012.
18. The 12th Five Year Plan 2011-15 shifts emphasis from investment towards consumption and development and from urban and coastal areas toward rural and inland areas. This implies much lower reliance on growth through exports, with the previous aim of a competitive renminbi exchange rate a lower priority than in the past.
19. This should diminish households' savings need, since an enhanced real return on savings enables the same return as previously to be reached with much less outlay, and would spur household domestic spending. It should also decrease price pressures on the few potentially rewarding assets available for Chinese domestic investment, notably housing.
20. See, for example, statement by David Li, former member of PBoC Monetary Policy Committee, Boao Forum, April 2012.
21. 'The Connecting Dots of China's Renminbi Strategy: London and Hong Kong', Paola Subacchi and Helena Huang, Chatham House Briefing Paper, September 2012.
22. See for example, Catherine Schenk, 'The Origins of the Eurodollar Market in London 1955-63', Explorations in Economic History, vol. 35(2), p. 221-38, April 1998.
23. There have been numerous reports that China is placing quantities of domestically-minded production into government accounts but has not yet labelled these as officially part of Chinese reserves. Chinese officials have from time to time indicted that official figures on China's gold reserves understate actual amounts held. The reported rise in imported gold from Hong Kong (489 tonnes in the 12 months to April 2012, up from 66 tonnes in the previous 12-month period) has been interpreted as a sign of increased official buying. Austria's Erste Bank, among others, has referred to reports that China is attempting to bring its gold reserves up to at least parity with the US (8,133 tonnes in July 2012), or possibly even higher.
24. The components of the SDR, since 2000, have been the four currencies officially designated by the IMF as reserve currencies: the dollar, euro, yen and sterling.
25. People's Bank of China statement, 23 March 2009.

26. 'Directors noted that although China has become the third-largest exporter of goods and services on a five-year average basis and has taken steps to facilitate international use of the currency, the Chinese renminbi does not currently meet the criteria to be a freely usable currency and it therefore would not be included in the SDR basket at this time. Directors urged that this issue be kept under review in the light of developments.' IMF Public Information Notice, 17 November 2010. This cautious language was basically upheld, with minor modifications, in a further statement on 11 November 2011. 'Directors welcomed the clarifications of the existing criteria…with most being of the view that the current criteria for SDR basket selection remain appropriate. Directors stressed that the bar for SDR basket inclusion should not be lowered…Most Directors agreed that there continues to be an important role for a size-related criterion for SDR basket selection…Directors agreed that the number of currencies in the SDR basket should not be prejudged. They generally considered that, as the SDR basket evolves in due course, its size should remain relatively small to avoid adding undue costs and complexity for SDR users.'
27. The People's Bank of China view since early 2012 is that the renminbi's exchange rate is 'close to its equilibrium level' – a phrase used by Yi Gang, deputy governor and head of the reserve-holding body State Administration of Foreign Exchange (SAFE), at the National People's Congress in February 2012.
28. When China's foreign exchange reserves reached the $1tn level in 2005, People's Bank of China governor Zhou Xiaochuan said: 'We have enough.' Arguably, China's accumulation of dollar assets was one of the causes of the build-up of bank liquidity and inadequate risk assessment that led to the Great Recession of 2008-09. China's dollar assets eventually must find their way into the US banking system, where they swell US banks' balance sheets and enable banks to lend more, a major contributor to the credit boom.
29. According to the IMF, China's current account surplus is expected to amount to around 3% of GDP in coming years, against 6% for Germany.
30. Research report from Sheng Songcheng, head of the statistics department of People's Bank of China, February 2012. This was published by Xinhua, the state news agency, rather than the PBoC, suggesting that the objective was to provoke debate rather than to introduce a fully workable plan.
31. The PBoC report contained some critical comments about the overall cautious approach. 'By overemphasising preconditions [for reform] a gradual approach is easily twisted into a negative immobile approach, leading to delays.' But the document ended up effectively endorsing this stance.
32. Before August 2011, with international credit conditions relatively loose, and renminbi appreciation expectations prevalent, market participants took on more dollar liabilities, purchasing dollars offshore and selling them onshore and thus aggravating capital inflows. With the worsening European debt crisis, international credit conditions tightened after August 2011 and market participants ran down dollar liabilities, selling dollars offshore and purchasing them, with the result that capital inflow pressures were relieved and the domestic market was even faced with a dollar shortage for a period.
33. In a point made by Jin Zhongxia, head of the Research Institute of the People's Bank of China, the dollar supplanted sterling as the world's main reserve currency only after the end of the Second World War, 70 years after the US took over from the UK as the world's largest economy.
34. BIS survey, 2010.
35. Hong Kong deposits in renminbi dropped slightly from Rmb580bn in October 2011 to Rmb554bn in March 2012.
36. Even among leading Asian economies that have a clear interest in holding renminbi in reserves, the Chinese currency's share of reserves is thought to be no more than 4%. The IMF data on reserves include only fully convertible currencies.
37. Announcement by Sanusi Lamido Sanusi, Governor, Central Bank of Nigeria, 5 September 2011.
38. Austrian National Bank announcement, 10 November 2011.
39. Swiss National Bank website, August 2012.
40. Hong Kong's Chinese Gold & Silver Exchange Society officially started trading gold denominated in renminbi in October 2011. The Hang Seng RMB Gold ETF was launched in February 2012.
41. Details about the UK transactions remain somewhat unclear. See Gianni Toniolo, with the assistance of Piet Clement, 'Central Bank Cooperation at the Bank for International Settlements 1930-73'.
42. This shows that Gresham's Law ('Bad money drives out good') only operates if the exchange rate between the two currencies is fixed. If it fluctuates, Gresham's Law goes into reverse and good money drives out bad.
43. In practice, these three aspects are mixed. An oil-exporting country may, for example, choose to denominate part of its sales of energy to China in renminbi, will hold stocks of renminbi in its reserves and will wish to carry out renminbi bond issues in either Hong Kong or Shanghai.
44. T.M. Weguelin, Governor of the Bank of England to the House of Commons in 1857, quoted in Timothy Green, 'Central Bank Gold Reserves – an historical perspective since 1845', World Gold Council, November 1999.
45. Ibid.
46. In fact, the period was not a depression at all, but a falling-price boom.
47. Barry Eichengreen, 'Exorbitant Privilege – The Rise and Fall of the Dollar', New York, 2011, p 17.
48. Ibid.
49. Green, p 11.
50. See, for example, Yi Gang, director of SAFE and deputy governor, People's Bank of China, 'We think the global financial system dominated by the dollar will remain unchanged for some considerable length of time … We have very realistic and sober views about our currency. China is still a developing country. Its economy has grown in size, but it will be some time before the yuan becomes a completely convertible currency and it will be much longer before it becomes a reserve currency.' Interview Asahi Shimbun, 23 August 2012. See also warning by Hu Xiaolian, People's Bank of China deputy governor, of 'systemic risks involved with the yuan's use in international trade and investment'. She said that the central bank will set up a system to identify and monitor such risks and use market-based tools to manage them. Lujiazui Forum, Shanghai, 30 June 2012.
51. The 1947 episode is important for another reason: It was the first overt post-war American anti-sterling move. A far more serious attack came during 1956 Suez Crisis, when the US government deliberately caused a run on sterling and refused to help until Britain (and France) had caved in to American demands to abandon the war against Egypt.

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